

Effective Date: May 7, 1992

**COORDINATED ISSUE  
ALL INDUSTRIES  
EMPLOYMENT CONTRACTS**

Issue:

Whether employment contracts entered into by a target company during acquisition negotiations are an asset of the target company where there is no substantial business purpose for the target company to enter into the employment contracts independent of the proposed sale of the company.

Facts:

A company was interested in acquiring the stock of three closely-held companies. The major stockholders of each company were also key employees who had close personal contacts with the closely-held companies' customers. As a condition of the acquisition, the acquiring company required each of the target companies to enter into employment contracts with its key employees. These contracts ensured that the stockholders/key employees would continue in the acquiring company's employ for a period of time after the stock was acquired and would thereafter not compete with the acquiring company for a number of years.

When a taxpayer purchases the assets or stock of a business, it can allocate the purchase price to the various assets to the extent of their fair market values. (Former) I.R.C. Sections 334(b); 338 or 1060. Any purchase price remaining after this allocation is characterized as goodwill or going concern value, which is not amortizable as a matter of law. This describes the residual method of basis allocation required under section 1060 for applicable asset acquisitions and for stock purchases after January 29, 1986, for which a section 338 election was made. However, for stock purchases prior to and including January 29, 1986, the basis of the various depreciable assets could be determined theoretically under both section 334(b) or 338 by valuing goodwill and/ or going concern value separately and then allocating the purchase price according to relative asset values. Immediately after acquiring each target company, the acquiring company liquidated the target company. The acquiring corporation treated the employment contracts as assets received from the closely-held corporations and allocated a substantial portion of its basis in the stock to the contracts. Further, the acquiring corporation claimed the contracts were amortizable assets that could be written off over their useful lives.

Law :

In Barnes Group, Inc. c. United States, 872 F.2d 528 (2d Cir. 1989), the Second Circuit determined the applicable test to determine if employment contracts are an asset of the acquired company. The delineated test is whether:

- (1) The employment contract was entered into prior to the sale of the acquired company;
- (2) The employment contract was not conditioned upon the sale of the acquired company; and (if (1) and (2) are met)
- (3) The acquired company had a substantial business purpose independent of the proposed sale of the company for entering into the employment contract.

872 F.2d at 532.

Upon remand, the district court held that the employment contracts were executed essentially simultaneously with the executions of the stock purchase agreements, but prior to the consummation of the acquisitions. The district court further determined that the contracts were expressly conditioned upon the consummation of the acquisitions. Further, the court found that the employment contracts were not entered into for a substantial business purpose of the target companies. Barnes Group, Inc. v. United States, 724 F. Supp. 37 (D. Conn. 1989), aff'd, 902 F.2d 1114 (2d Cir. 1990).

In the Barnes case, it was evident that the employment contracts were expressly conditioned on consummation of the acquisition because the contracts stated they would be of no force and effect unless the acquisition was consummated by a certain date. However, even where the contract is not expressly contingent on the acquisition, the facts and circumstances surrounding execution of the employment contract should be examined to determine if there is an intent, either express or implied, that the contract be dependent on the occurrence of the acquisition.

Furthermore, even if the employment contract was entered into prior to the sale of the company and the contract was not dependent on the acquisition, the employment contract is not an asset of the acquired company unless the acquired company entered into it for substantial business purposes independent of the proposed acquisition. Although several officers/key employees of the acquired companies attested to an independent business purpose of the target companies in entering into the contracts, the district court examined the record objectively. The district court primarily relied on the following facts in making its determination. The acquired companies saw no need for the employment contracts until negotiations began for the sale of each company. The acquired companies could have no business purpose in entering into such agreements on the eve of dissolution and the agreements could not satisfy a business

need once the companies were dissolved. The acquired companies did not obtain anything of value until the acquisition of the companies. The employees received no consideration and, thus, had no enforceable obligation until the acquisition was complete. No purpose of the acquired companies could be served by a contract which would have no effect until the target companies' stock was acquired. No ongoing business purpose of the acquired company could be served by an agreement which could be vitiated by an event (nonconsummation of the acquisition) which had nothing to do with the ongoing conduct of the acquired companies' businesses. 724 F. Supp. at 42. The district court had previously found that the contracts were executed at the instigation of the acquiring company, for its purposes and not for purposes of the acquired companies at the time the contracts were executed. 724 F. Supp. at 40. It is likely that most of these facts will be present in any case where this issue arises.

On remand, the district court addressed a case upon which the taxpayer relied, holding it was inapposite to the facts of Barnes because the employment contracts were not contingent on the acquisition taking place. In KFOX, Inc. v. United States, 510 F.2d 1365 (Cl. Ct. 1975), during purchase negotiations, the purchaser imposed two conditions that had to be met before the purchaser would enter into a firm sales agreement. One of these conditions was that the target radio station had to enter into employment contracts with its leading air personalities. Once the requirements had been met, the sales agreement was signed contingent on FCC approval. The Claims Court determined that the employment contracts were severable from goodwill and that they had an ascertainable value. Therefore, the purchaser was entitled to amortize them.

KFOX and Barnes are factually analogous. However, the court in KFOX erroneously used a definition of goodwill describing it as "a catchall term for all of a going business' intangible assets that are associated with its profitability." 510 F.2d at 1376. As such, the Court reasoned that goodwill was divisible into its component parts and found that the contracts had "significant and measurable value independent of their direct contribution to the value of the [target's] goodwill . . . ." Id. at 1377. Accordingly, the Court permitted the contracts to be amortized.

In deciding this case, the Court should have used its first announced definition of goodwill i.e., "the intangible value of a going concern which is associated with the reasonable expectancy that old customers will return to the concern . . . without any contractual compulsion." Id. Had the Court used this description of goodwill, the amortization of the contracts would not have been permitted. More important, if the Court in KFOX had used the test annunciated in Barnes, the outcome would have certainly been different.

Consequently, it is apparent based on KFOX, that the main thrust of our argument should be that the employment contracts were not entered into for a substantial

business purpose of the target corporation independent of the proposed sale of the target. If this prong had been argued in KFOX, the result of the litigation would presumably have been different. It is doubtful that the target company in KFOX could have demonstrated a substantial business purpose for entering into the contracts independent of the proposed sale for the same reasons that the district court addressed in Barnes. Thus, the purchaser could not have amortized the employment contracts under the Second Circuit's test in Barnes.

In conclusion, an employment contract entered into by a target company is not an asset of the target company, unless 1) the contract was entered into prior to the acquisition of the target company; 2) the contract was not conditioned upon the sale of the target company; and 3) the contract was entered into for substantial business purposes independent of the proposed sale.